

THE MUHLENKAMP MEMORANDUM

(Quarterly Letter continued)

Where are we today?

There are two main questions yet to be answered:

1. Is there another big surprise that could hit the markets?

Yes, always.

2. Having changed their investing patterns; will people change their spending patterns?

Changes in spending affect the economy. We saw it happen in 1990 with the Gulf War. However, it did not happen in 1987 or 1994 when we had market declines without economic declines. At this point, the economy is still doing well. Six months ago, the Fed wanted a slow-down in the economy. Today, investors fear a slow-down in the economy. The only difference between six months ago and today is that stock prices are down. The jury is still out as to whether a decline in the stock market will drive a decline in the economy.

In the past month, we heard from Dr. Milton Friedman and Dr. James Tobin, both Nobel Prize winning economists. Milton Friedman probably knows more about the Great Depression than anybody living today. Dr. Tobin was an economist for the Kennedy administration. Dr. Friedman said that the odds of a worldwide economic depression are trivial, while Dr. Tobin said the odds are quite small. We believe that problems and perceptions have to get pretty bad for governments to change. You have to go through a certain amount of pain just to get government attention. But national governments are beginning to respond. Japan has just passed meaningful legislation and our federal government has now lowered interest rates by a quarter of a point, twice. Both are responding to the slow-down instead of worrying about inflation (the reverse of three months ago). We believe there has been enough pain inflicted, and it has scared enough people that further actions will be taken by government bodies. Unless an additional major problem hits the fan, it is a great time to invest. We still have 10-20% of our assets in cash and Treasury bonds. We are starting to put that money back to work in stocks, because we are seeing some great companies at very cheap prices. We do believe that there will be continued selling through the end of the year for tax-loss purposes. We don't think we have to be in a big hurry, but it is a time to do our homework and prepare to buy the values we see.

If you wonder about the wisdom of what we are doing, or have trouble sleeping at night, we suggest that you take a close look at the companies whose stock we own. Think of them as businesses, not pieces of paper; review their balance sheets, their income statements, and their cash flow statements, then determine whether you're comfortable investing in these companies at the current prices. And remember that our money is invested in these companies right along with yours.

-- Ron Muhlenkamp

MORE ON ROTH IRA'S

Dad asked me to write down on a single page my ideas about the Roth IRA and whether someone should convert a Traditional IRA to a Roth IRA. Unfortunately, I can't do it; there are too many rules and exceptions to the rules, and you have to take into account too many separate but related issues. What I can do is direct you to resources and share some of my conclusions.

You can find excellent resources for understanding the rules and the implications at www.rothira.com. Laura Sanders has written good articles on IRAs and Roth IRAs for Forbes magazine and many of those are collected at www.forbes.com/forbes/by/LSaunder.htm. Mutual Fund Magazine has published good articles in the August and September 1998 issues. Finally, there are plenty of books and software programs available on how to make the conversion. One rigorously thorough book and program is available to determine the optimal conversion amount and for planning pension distributions at www.rothirabook.com.

All the authors I've read favor the Roth IRA and converting a Traditional IRA to a Roth. I believe it is a good idea to fund a Roth each year, even if you can make deductible contributions to a Traditional IRA. I am more skeptical of the conversion, and here is why.

1. Lawyers, accountants and financial planners write the articles and treat the current laws and rules as permanent. Yet the rules are constantly being written and re-written. For example, the Technical Corrections Act changed the 5-year holding rule so now your 5 years begins with the first Roth IRA contribution of any kind. There is no longer a need for more than one Roth account. Just 3 months ago the cutting edge advice was to have a separate Roth for \$2,000 contributions and one for each rollover or conversion from a Traditional IRA. (See the article by Natalie Choate dated 8/19/98 at www.rothira.com for good explanations of the Act). Also, no one recognizes the fact that all IRA and Roth IRA rules are exceptions to rules Congress made decades ago. Taxing capital gains and income from investment did not come down with Moses from the mountain, but was made up by Congress. Without that original rule, the IRA and the Roth IRA are redundant and unnecessary. There is a lot of merit and some attention being paid to the idea of repealing that rule with a Flat Tax.

2. Most commentators stress that conversion to a Roth is the most beneficial if you pay the conversion taxes from assets outside the IRA, yet they gloss over how you can invest those outside assets. When they mention it at all, they assume you invest for current income so the after tax rate of return is always much less than you can get inside the Roth. They seem to ignore the tax flexibility and returns you can achieve by

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(More on Roth IRA's continued)

investing in equities. I think the better you are at tax-efficient investing, the less compelling the argument for converting to a Roth.

3. Deciding whether to convert and how much is "optimal" to convert requires making a tremendous number of assumptions. The software I have seen either requires too little input, which means it overlooks some factors; or too much input, which means the answer you get is nonsense. All those assumptions have to be true for your result to be true. In my case, I was making assumptions about life expectancies, salary, inflation, investment returns, spending requirements, income tax rates, capital gains rates, estate tax rates, and whether my daughter will help support my wife. I was making these assumptions for the next 90 years. My spreadsheet told me that my family would have more money after all taxes when I reach age 86 if I convert my Traditional IRA to a Roth. Until age 86, it looks like I'm better off not converting (I'm currently 34). All I really know for sure is that if I convert to a Roth, I will owe \$15,000 in additional income taxes over the next four years. That assumes our family income doesn't change at all in the next four years.

4. The experts refer to the advantage the Roth IRA has over the Traditional IRA resulting from tax-free compounding after age 70 1/2 and even after death. These advantages are also available to the Traditional IRA holder to a lesser extent by choosing a child or grandchild as primary beneficiary. The advantage dissipates if the IRA holder actually needs the money during his lifetime and is pulling money out each year to spend.

If you don't need the money from a Required Minimum Distribution (RMD) you can find something useful to do with it. You can give that money to your heirs and remove it from your estate. By paying the income tax on the RMD, and gifting it, you remove that money from your estate. The experts mention reducing your taxable estate by paying conversion taxes; but they ignore paying income taxes on a RMD from the Traditional IRA and reducing your estate that way. If you give the money to your heirs you must also give them the authority and responsibility for investing it well and wisely. Frankly, that is the more difficult piece.

5. I have not seen any discussion of the compliance and reporting issues associated with converting to the Roth. I suspect the IRS is going to calculate the basis of a Traditional IRA using Form 8606 that people file each year with their tax return. I also suspect many people have made non-deductible contributions to their IRA each year without filing form 8606. Which means the amount of the conversion they think is taxable will be different from what the IRS says is taxable. I have no idea how it will all shake out, but I don't want to be the one to try and explain to the IRS. Bottom line, if there was not

such a steep up front cost to converting a Traditional IRA to a Roth it would be a no brainer. The question is whether the advantages promised by a Roth are sufficient to justify the up-front cost of converting. I am not convinced; I think you can achieve most of the advantages of the Roth without converting and paying conversion taxes. It really depends on what you are trying to do and when.

I won't argue if someone wants to convert his or her Traditional IRA to a Roth. I simply want to confirm their eligibility, that they have the money to pay the conversion taxes from outside assets, and that they have done the work and checked their assumptions so they know what they are paying and what they expect to get. However, I wouldn't try to finagle my Adjusted Gross Income below \$100,000 just to be eligible either.

Personally, I will keep my Traditional IRA intact and make contributions to the Roth; today you must have AGI below \$100,000 to convert to a Roth and below \$160,000 to make Roth IRA contributions. Each year I will review my eligibility and my options and decide which IRA to contribute to and whether or not it makes sense to convert to a Roth. This is not a one-time decision and I fully expect to learn more in the upcoming years.

Please let me know if you have questions or comments.
-- Tony Muhlenkamp

CAPITAL GAINS DISTRIBUTION

Articles will soon appear telling investors to wait until next year to invest in the taxable accounts of their mutual funds, in order to avoid buying into year-end capital gains distributions. This may be true for some mutual funds with high portfolio turnover, but it has not been the case for the Muhlenkamp Fund over the last 10 years. This year is no exception, since the Fund will pay no capital gains distribution in 1998.

SHAREHOLDER CORRESPONDENCE WITH THE MUHLENKAMP FUND

Please use one of the following addresses to contact the Muhlenkamp Fund by mail:

1. For subsequent investments to an established account, send your check and investment stub to: Muhlenkamp Fund, PO Box 799, Cincinnati, OH 45264-0799.
2. To open a new account, redeem shares from your existing account, change your address or account registration, enroll in or change your Automatic Investment Plan, or communicate anything about a specific account, write to:
VIA REGULAR MAIL: Muhlenkamp Fund, c/o American Data Services, PO Box 5786, Hauppauge, NY 11788-0164
or VIA OVERNIGHT MAIL: Muhlenkamp Fund, c/o American Data Services, 150 Motor Parkway, Suite 109, Hauppauge, NY 11788-0164.

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JOIN THE BILLION BYTE MARCH TO SAVE AND REFORM SOCIAL SECURITY

Dear Friends,

I am asking for your help in an effort to save and reform Social Security. Congress and the White House will be debating this issue over the next several months, so now is the time to act and let your voice be heard.

Each of us has paid into the Social Security system via payroll taxes; therefore, we all feel entitled to receive something from the system during retirement. Many people today use Social Security as their primary means of support during retirement - they think of it as a pension plan. Most people are not aware that the Social Security System was never intended to be a pension plan, and it is not administered like a pension plan. This is why the system is projected to run annual deficits by the year 2012.

When the Federal Insurance Contribution Act (FICA) was created in 1937, it was designed as an insurance plan for retirees who needed assistance. Payroll taxes of 2% were collected from workers to provide benefits only to those who needed it. This changed dramatically over the next several decades, and now we are to the point where every retiree collects, and the wealthiest Americans collect the most. This is anything but insurance!

The current system works as long as there are more workers paying into the system than there are retirees drawing from the system, and if current workers are willing to pay the taxes to support the system. There is no Social Security "Trust Fund", since current payroll tax receipts are paid to current recipients and any surpluses are used to mask the size of the federal budget deficit. The system is called "pay as you go" because current workers pay the benefits of current retirees. The money that current retirees contributed to the system was paid to their parents and grandparents long ago. In 1945, there were 20 workers for every retiree, so the pay as you go system worked well and payroll taxes amounted to just 2%. At that time, Americans worked into their late 60's and passed away in their early 70's, so Social Security benefits were only paid to most Americans for a few years.

Today there are only 3 workers for every retiree, and life expectancy is increasing, along with years in retirement. Therefore, payroll taxes have increased over 6 times to 12.4% to provide the same benefits. It is projected that by the year 2030 there will only be 1.8 workers per retiree. Before 2030, either retiree benefits will need to be cut by 40%, or the payroll tax must be increased to 18% or more. It is apparent that retirees don't want fewer benefits, and it is equally apparent that the next generation of Americans will not be able to pay the tax bill to support retirees. Something must be done now!

As the recently elected Chairman of the 100% No-Load Mutual Fund Council, I have been working closely with representatives of Economic Security 2000 to disseminate the message of Social Security reform. The Council has become a National Co-Chair of The Billion Byte March, an e-mail March on Washington, D.C. to persuade our elected representatives to adopt Social Security reform now. U.S. Senator's Bob Kerrey (D-NE), Rick Santorum (R-PA), and Chuck Robb (D-VA) have also joined The March as Honorary Co-Chairs. By registering for The Billion Byte March, you can help save and reform Social Security.

The mission of The March and Economic Security 2000 is to preserve the social safety net of Social Security, while allowing individuals to invest a portion of their payroll taxes (2 to 4% of the 12.4%) in private sector investments held in privately owned accounts. This would be done in much the same way that people save for retirement in IRA and 401(k) accounts today. This new system would allow benefits to remain stable, while keeping payroll taxes in check. It will also give many Americans their first exposure to the long-term benefits of equity investing.

I hope you will join me in these efforts to save and reform the Social Security system. Please sign-up for The March on the internet at www.march.org. If you don't have internet access, call **1-888-773-2287** to voice your support. All responses will be e-mailed to the White House and Congress on the same day around the State of the Union address in January, 1999, so act now! If you would also like to get involved at the grassroots level, please contact Economic Security 2000 at **1-888-773-2287**.

Cordially,
Grant Duffield

P.S. Please pass the internet address or phone number of The March along to your friends and family members.

MUHLENKAMP FUND AVERAGE ANNUAL RETURNS AS OF 9-30-98

One Year

-8.48%

Three Years

18.17%

Five Years

14.04%

Since Inception
(11-88)

14.41%

Please read the prospectus carefully before you invest. Past performance does not guarantee future results. Fund shares when redeemed may be worth more or less than their original cost.